Uncertainty in the Short-Run Economic Outlook

The most uncertain components of the economic projection are the future behavior of real interest rates and inflation. A resurgence of inflation or a substantial rise in interest rates could result in another period of cyclical decline. Fiscal and monetary policy appear to be the major source of uncertainty in the outlook for inflation and for credit conditions. Many observers fear that the budget issues will not be resolved quickly and that the absorption of savings by the federal sector, which has recently been at record rates (see Figure 3) will continue at a high rate during the year ahead. Given recent signs of strength in the economy, competition for funds between the federal government and others could emerge quickly, resulting in more stringent credit conditions than projected by CBO. This would have adverse effects on housing and other interest-sensitive sectors as well as on net exports. On the other hand, interest rates could turn out to be lower than forecast or their effects on demand less pronounced. Thus far, in the current recovery, forecasters have underestimated the strength of demand in the face of high interest rates.

In regard to monetary policy, it is not clear whether the Federal Reserve will attempt to rein in money growth, especially in view of the precarious foreign debt situation of developing countries and the opposition to higher interest rates expressed by some members of the Administration and the Congress. As a result of the recent decline in velocity—the ratio of GNP to the money stock—there is also an unusual degree of uncertainty concerning the economic effects of Federal Reserve money targets. 3/ The rapid growth in money during the past year could lead to a surge in economic growth, if there is a snapback in velocity. On the other hand,

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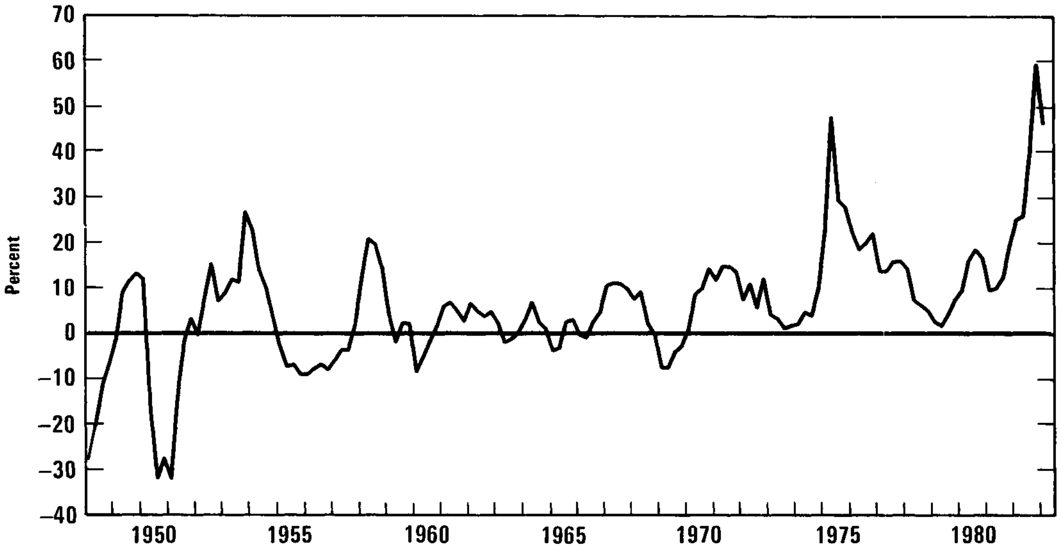
3/ From the end of 1981 through the first quarter of 1983, M1 velocity—the ratio of GNP to the narrowly defined money stock—declined by an unprecedented 6.9 percent, and in the second quarter it remained about 7 percent below the trend established in the 1960-1980 period. Although past experience indicates that a cyclical rebound in M1 velocity is likely, velocity may not return to the earlier trend path if the fall in velocity resulted from declining inflation expecations or from changes in regulations pertaining to bank deposits. The average increase in M1 velocity is about 5½ percent during the first four quarters of a cyclical recovery. However, velocity declined sharply in the first quarter of this year and increased only slightly in the second, suggesting that a normal cyclical rebound may not occur. Thus, it now appears that a wide range of nominal GNP growth could be implied by a given M1 growth target.

Figure 3.
Federal Deficit as a Percent of Gross Saving



SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

Federal Reserve policies to limit money growth may turn out to be more restrictive than intended.

Economic Projections for 1985 and 1986

Table 3 compares the CBO economic projections through 1986 with the Administration's projections and the economic assumptions of the recently enacted budget resolution for fiscal year 1984. These projections do not differ greatly, although the CBO projections incorporate more recent information on unemployment rates.

The CBO projections for the 1985-1986 period are not forecasts; rather they are noncyclical projections that assume that the economy moves gradually toward higher employment levels. Nominal GNP growth is assumed to decline in line with reduced money growth. In real terms, GNP growth is assumed to be 4.0 percent in calendar 1985 and 3.5 percent in calendar 1986. It is further assumed that no price shocks occur and that productivity grows at a trend rate of 1½ percent per year. This projection

TABLE 3. SUMMARY COMPARISON OF ECONOMIC ASSUMPTIONS
(By calendar year)

	Actual 1982	Estimated 1983	Projections 1984	1985	1986
Real GNP (percent change, year over year)					
First budget resolution	-1.9	2.8	5.1	4.1	3.7
Revised CBO	-1.9	3.1	5.0	4.0	3.5
Administration	-1.9	3.1	5.2	4.2	4.0
GNP Deflator (percent change, year over year)					
First budget resolution	6.0	4.7	4.6	4.7	4.3
Revised CBO	6.0	4.5	4.8	4.8	4.8
Administration	6.0	4.6	4.8	4.9	4.6
Unemployment Rate (percent, annual average)					
First budget resolution	9.7	10.1	9.3	8.5	7.9
Revised CBO	9.7	9.7	8.4	7.9	7.5
Administration a/	9.7	10.1	9.1	8.4	7.5
3-Month Treasury Bills (percent, annual average)					
First budget resolution	10.6 b/	7.8	7.4	7.2	6.6
Revised CBO	10.6 b/	8.8	8.6	7.7	7.4
Administration	10.7 c/	8.6	8.5	7.8	7.2

a/ Administration's total resident unemployment rate plus 0.2 to approximate the civilian rate.

b/ Current market yield.

c/ Average rate on new issues, bank discount basis.

implicitly requires that the recovery last longer than most other recoveries since the war, despite considerable uncertainty over monetary and fiscal policy.

THE CBO BUDGET PROJECTIONS

Last February CBO's baseline budget projections showed federal budget deficits rising indefinitely from current record levels with the deficit to GNP ratio holding to about 5.6 percent during the 1984-1986 period. But the budget resolution adopted in June will turn this around if it is implemented. Under the policies of the resolution, and given the improved economic outlook, CBO estimates that the budget deficit will decline from about $207 billion in the current fiscal year to about $146 billion in fiscal year 1986 even if the reserve fund is spent. As a percent of GNP, the deficit will decline from its current level of about 6 percent to about 3 percent in 1986 (see Table 4).

The federal deficit for the current fiscal year is now estimated to be about $13 billion higher than anticipated last February, reflecting both higher outlays and lower revenue collections. Despite the higher 1983 deficit, CBO's revised budget projections show a $5 to $14 billion lower deficit in fiscal year 1984 and an $85 to $88 billion lower deficit in fiscal year 1986 depending on the outcome of the reserve fund. Most of the near term reduction is accounted for by recently enacted budget measures (including the Social Security amendments of 1983) and stronger economic growth. The major impact of policy changes called for in the budget

TABLE 4. CBO UNIFIED BUDGET PROJECTIONS GIVEN POLICIES OF BUDGET RESOLUTION FOR 1984 (By fiscal year)

	Actual	Estimate	CBO Projections		
	1982	1983	1984	1985	1986
			In Billions of Dollars		
Revenues	618	600	677	748	842
Outlays	728	807	860 to 868	924 to 929	986 to 989
Deficits	111	207	183 to 192	176 to 180	143 to 146
			As a Percent of GNP		
Revenues	20	19	19	19	20
Outlays	24	25	24	24	23
Deficit	4	6	5	5	3

resolution does not occur until after 1984. By 1986, they account for about 75 percent of the reduction in the projected deficit.

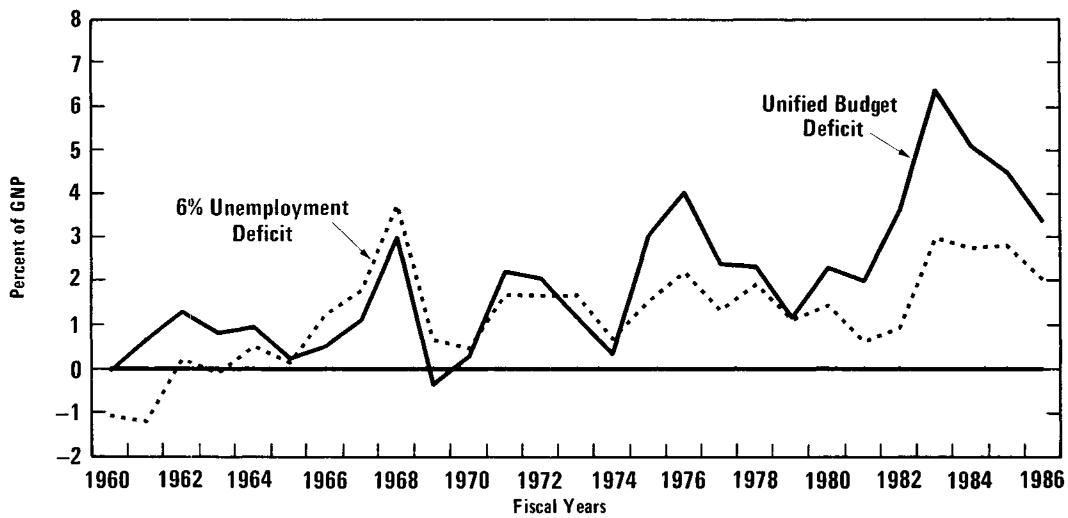
Both the budget resolution and the Administration's budget proposals would have a similar effect on the overall deficit in the next several years, but they differ sharply in their policies. The composition of spending is the major issue: the Administration seeks significantly higher levels of defense spending and much lower levels of nondefense spending. The Administration has proposed somewhat greater overall spending reductions, and tax increases that are smaller until 1986. Because of these differences in the policies of the Congress and the Administration, there is a strong possibility that the deficit reduction measures will not be realized.

Structural Deficits

Much of the current deficit is the result of recession, but even after recovery the federal budget will show large deficits (see Figure 4). These "structural" deficits will be over $100 billion in fiscal year 1985, even

Figure 4.

Federal Deficits as a Percent of Gross National Product



SOURCES: Office of Management and Budget; U.S. Department of Commerce, Bureau of Economic Analysis.

if the policies of the resolution are enacted. The structural deficit will not decline until 1986. However, by then it will be substantially below CBO's estimate made last February before enactment of the resolution (see Table 5). (Estimates of the structural deficit for fiscal years 1983-1984 have been increased since February because of policy changes enacted since that time, a variety of technical reestimates, and higher interest costs). Even though the structural deficit will be substantially reduced in 1986 under the policies of the resolution, it will be very high in absolute terms, suggesting the possibility of high interest rates and crowding out of productive investment during the recovery. Without the resolution policies, or similar deficit-reducing measures, the deficit will rise relative to GNP, causing an even greater strain in financial markets.

TABLE 5. THE STANDARDIZED EMPLOYMENT DEFICIT a/

	Actual 1982	Estimate 1983	Projection 1984	Projection 1985	Projection 1986
		In Billions of Dollars			
February 1983 estimate b/	29	69	91	128	159
August 1983 estimate c/	29	97	99	110	87
		As a Percent of Standardized GNP			
February 1983 estimate b/	0.9	2.0	2.5	3.1	3.6
August 1983 estimate c/	0.9	2.8	2.6	2.7	2.0

a/ Unified budget estimate standardized at 6 percent unemployment.

b/ Congressional Budget Office, The Outlook for Economic Recovery (February 1983). The 1982 levels have been revised to reflect the revisions in economic data for that year.

c/ These estimates exclude expenditures from the "reserve fund". If enacted, the programs included in the reserve fund would cost $9 billion in fiscal year 1984, $5 billion in 1985, and $4 billion in 1986, given CBO's economic projections. The cost would be less at full employment because spending for these programs is likely to be sensitive to the level of unemployment.

CONCLUSION

Economic growth has been stronger and inflation lower in the first half of 1983 than anticipated by CBO last winter. But the recovery still appears to be precarious because of high interest rates and uncertainty concerning the future course of both monetary and fiscal policy. While the more rapid recovery tends to reduce federal budget deficits, it also brings closer the time when competition for credit between the public and private sectors will intensify. High deficits raise the risk (1) that tight credit conditions will choke off the recovery in interest-sensitive sectors of the economy; or (2) that the Federal Reserve will monetize large portions of the deficit, thereby ensuring the resurgence of inflation. Thus, enactment of suitable policies that substantially reduce future deficits could make a major contribution to sustained noninflationary growth.

Even if the economic recovery is stronger than projected, the budget deficits will remain very large without further deficit-reducing measures. The budget resolution enacted in June begins the process of reducing the deficits. But the resolution was merely the first step. Decisive action by the Congress and the Administration is necessary to ensure that these or other deficit-reducing measures are actually put into effect.

CHAPTER II. THE BEGINNING OF ECONOMIC RECOVERY

The recovery from recession is well under way. Although economic activity was below standard in the first quarter of the recovery, it picked up sharply in the spring and appears to be gaining momentum. 1/ Preliminary figures show real GNP increasing at an 8.7 percent annual rate in the second quarter of 1983, considerably faster than had earlier been thought. Industrial production and employment are growing rapidly, and the civilian unemployment rate fell from 10.8 percent in December to 9.5 percent in July.

The growth of output in the second quarter was mainly the result of a surge in consumer spending, which was weak in the early months of recovery but picked up sharply in April and May. Car purchases accelerated in response to lower market interest rates and interest subsidies, and purchases of household furniture and appliances rose as consumers began to equip newly built houses. The growth of consumer purchases greatly exceeded the reported growth in disposable incomes, with the result that the saving rate fell to 3.9 percent in the second quarter, a very low level.

While areas of weakness remain, notably in net exports, the economic recovery is now quite strong. In addition, inflation has fallen dramatically. Particularly important are the decline in oil prices, the strength of the dollar, and the deceleration of wage growth.

What has triggered the recovery?

- Monetary policy and credit conditions eased about a year ago. Interest rates remain high, but have fallen from the high levels of last summer.

- The federal deficit has increased sharply, even after allowing for the effects of the recession, implying a very large fiscal stimulus to the economy this year.

1/ Real GNP increased at an annual rate of 5.6 percent in the first two quarters compared to an average of 8.0 percent in the first two quarters of postwar recoveries. The National Bureau of Economic Research has dated the trough of the recession at November 1982. Thus the first quarter of recovery was the first quarter of 1983.

- o The episode of inventory reduction, the largest in the postwar era, which has dominated the recent recession appears to be near its end, setting the stage for increased production to meet consumer demand. Inventories fell only slightly in the second quarter.

These developments have created the potential for a rapid increase in economic activity in coming months. As a result of the surge in consumer spending, business inventories declined sharply relative to sales in the second quarter, pointing to continued rapid growth in employment and output in the current quarter. The resulting growth in income, together with the July personal tax cuts, will permit still further growth of consumption. Consumers' confidence, too, has been rising strongly, suggesting further growth in purchases of durable goods and of housing.

Questions remain. The recovery has been strongest in housing, autos, and other consumer durables, all of which are sensitive to interest rate movements. But interest rates are high, and have recently been rising. Continued increases could hold back the recovery in these sectors. High interest rates could also keep the exchange value of the dollar high and worsen the U.S. trade deficit even more, and they could limit the recovery of inventories and slow the growth of housing investment. Thus confidence in the strength of the recovery must be tempered with concern over the impact of high real interest rates.

This chapter examines the current state of the economy, with particular emphasis on:

- o The recent upturn in production, employment, and inventories;
- o Prices, interest rates, and exchange rates; and
- o The sources of prospective growth that must support a continued recovery.

Table 6, Table 7, and the box summarize recent economic developments.

THE UPTURN IN PRODUCTION

After a year and a half of recession, the U.S. economy is now growing rapidly. The recession led to a substantial reduction in inflation, particularly in commodity prices but also in wages, and it is unlikely that high rates of inflation will return soon. Although the cost of the improvement in

TABLE 6. QUARTERLY INDICATORS OF ECONOMIC ACTIVITY (Percent change from previous quarter at seasonally adjusted annual rates, unless otherwise noted)

	1981:4	1982:1	1982:2	1982:3	1982:4	1983:1	1983:2
Real GNP	-4.9	-5.5	1.0	-1.0	-1.3	2.6	8.7
Final sales	-2.3	-1.3	-0.8	-1.5	4.5	0.6	5.5
Personal consumption expenditures	-3.0	2.4	3.1	0.9	3.6	2.9	10.0
Durable goods	-22.9	11.3	3.0	-3.7	15.2	7.6	32.4
New autos	-55.6	61.6	4.7	-7.7	73.7	-10.8	79.5
Nondurable goods	0.3	-1.4	1.1	1.3	1.5	3.2	5.9
Services	1.4	2.9	4.7	2.1	1.9	1.4	6.8
Fixed investment	-7.8	-10.4	-9.3	-9.6	2.7	8.8	15.6
Nonresidential	-1.6	-5.9	-14.3	-8.8	-6.6	-1.5	4.6
Structures	7.8	-1.7	-2.6	-7.2	-5.5	-13.9	-14.0
Producers' durable equipment	-5.5	-7.8	-19.3	-9.6	-7.1	5.0	14.2
Residential	-30.2	-28.5	17.9	-13.0	53.2	57.3	61.1
Government purchases	3.9	-0.2	-5.0	9.4	10.6	-8.8	-0.9
Federal	10.0	0.2	-14.0	26.3	28.3	-18.0	-0.6
Defense	7.5	-1.3	13.0	14.0	5.1	6.5	14.1
Nondefense	15.0	3.3	-52.2	59.8	92.5	-52.6	-29.4
State and local	0.2	-0.5	1.3	-0.4	-0.1	-1.8	-1.0
Net exports (billions of 1972 dollars)	39.9	35.2	33.4	24.0	23.0	20.5	10.2
Change in business inventories (billions of 1972 dollars)	6.0	-10.2	-3.4	-1.3	-22.7	-15.4	-4.5
Real disposable personal income	-1.4	-3.4	1.9	-0.3	2.6	2.9	3.0
Saving rate (percent)	7.5	6.1	5.9	5.6	5.4	5.4	3.9
Industrial Production	-16.4	-12.0	-6.3	-3.4	-8.1	9.8	17.8
Unemployment Rate (percent, including resident armed forces)	8.2	8.7	9.3	9.8	10.5	10.2	9.9

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board; and U.S. Department of Labor, Bureau of Labor Statistics.

TABLE 7. STAGES OF RECESSION AND RECOVERY: CHANGES IN THE COMPONENTS OF REAL GROSS NATIONAL PRODUCT (In billions of 1972 dollars, at annual rates)

	Full Recession (1981:3 to 1982:4)	First Stage (1981:3 to 1982:1)	Second Stage (1982:1 to 1982:3)	Last Stage (1982:4)	Early Recovery (1982:4 to 1983:2)
Gross National Product	-45.1	-40.0	-0.1	-5.0	40.7
Inventory change	-38.8	-26.3	8.9	-21.4	18.2
Final sales	-6.3	-13.8	-8.9	16.4	22.5
Consumption	16.6	-1.5	9.6	8.5	30.9
Business equipment	-15.2	-4.2	-9.0	-2.0	5.0
Business structures	-1.3	0.8	-1.3	-0.7	-3.8
Residential	-2.5	-6.8	0.2	4.1	10.6
Defense	7.0	1.1	4.9	1.0	4.1
Federal nondefense	5.6	1.7	-2.6	6.5	-10.3
Excluding CCC	-1.3	-1.1	-1.1	1.0	0.6
State and local	0.2	-0.1	0.4	-0.1	-1.2
Net exports	-16.8	-4.6	-11.2	-1.0	-12.8
Exports	-22.5	-7.2	-5.4	-9.9	-2.3
Imports	-5.6	-2.5	5.8	-8.9	10.5
MEMO:					
Inventory Change Plus CCC Purchases a/	-31.9	-23.5	7.5	-15.9	7.3
Final Sales Excluding CCC Purchases	-13.2	-16.6	-7.5	10.9	33.4

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

a/ Commodity Credit Corporation (CCC) purchases of stocks of farm products are treated conventionally in the National Income and Product Accounts as a component of federal nondefense purchases and of final sales, although they are in many ways similar to inventory-building by farmers.

THE ECONOMY AT MID-1983

Recovery started in December 1982 from the deepest postwar recession, the second of two since 1980. Both recessions were brought on by monetary restriction aimed at bringing inflation under control. Lower interest rates after mid-1982 permitted the recovery to begin. Real GNP grew at a 2.6 percent annual rate in the first quarter and at an 8.7 percent annual rate in the second quarter of 1983.

Inflation has dropped dramatically in the last three years. The CPI grew only at a 2.9 percent annual rate in the first half of 1983.

Real consumption led the way out of the recession, increasing at a 7 percent annual rate in the first six months of 1983. Durable goods purchases, particularly for autos, furniture, and appliances, were responsible for much of the growth in consumption. Unseasonable weather caused an acceleration in energy purchases.

Personal savings dropped precipitously in the second quarter, according to preliminary reports. Interest income fell because of lower interest rates. Government transfers to persons increased less than usual in the first two quarters after the recession trough. Slowing of these income components and strong consumption cut the saving rate.

Inventories continued to decline in the first half of 1983, making the total inventory adjustment since the end of 1981 easily the largest in the postwar period. But the decline in the second quarter was small.

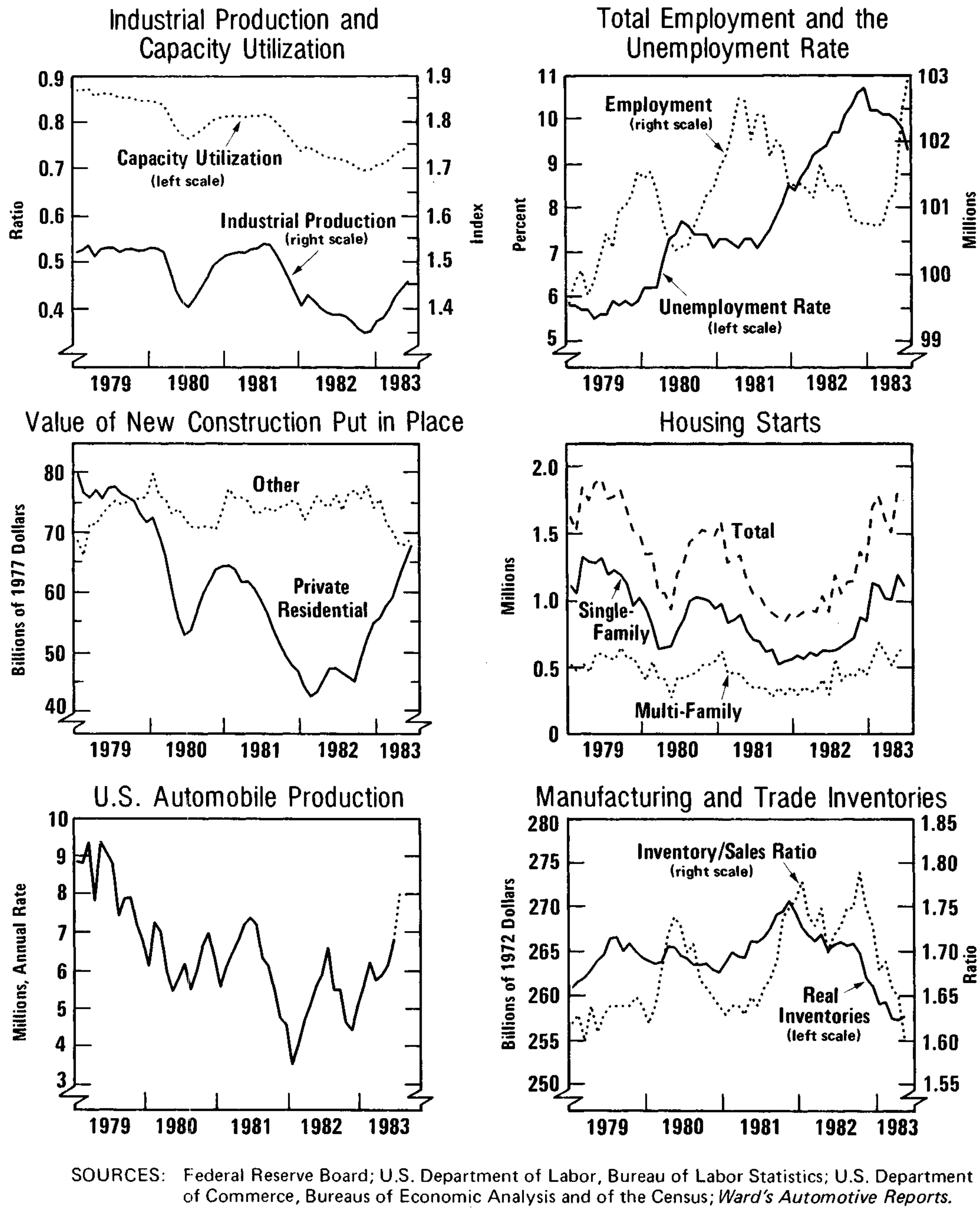
Net exports are still falling precipitously. Weak exports reflect the 50 percent appreciation of the dollar since mid-1980, as well as recession overseas. For the second time in two years, oil inventory reductions held imports down in the first half of 1983, but it seems likely that the deterioration in net exports will continue.

Crude oil prices fell sharply in early 1983, in response to reductions in refiners' inventories of petroleum products. The official OPEC marker price fell from $34 to $29. But product prices did not fall by the same amount, and as a result of the 5¢-per-gallon gasoline tax prices at the pump are now similar to what they were in mid-1982.

Unemployment dropped from 10.8 percent of the civilian labor force in December to 9.5 percent in July.

Housing starts began to rise in mid-1982 in response to lower interest rates, and are now 80 percent above year-earlier levels.

Figure 5.
Indicators of Economic Activity (Monthly)



SOURCES: Federal Reserve Board; U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureaus of Economic Analysis and of the Census; *Ward's Automotive Reports.*

inflation was large in terms of lost output and unemployment, both output and employment have risen sharply in the first six months of 1983.

The recent improvement in output is evident from Figure 5. Industrial production has increased 8.2 percent since November, and total private manhours worked have increased 3.7 percent. Housing starts are 80 percent higher than last year.

Employment

From a high of 10.8 percent, the civilian unemployment rate has dropped to 9.5 percent. 2/ This is still above the previous postwar high of 8.8 percent reached in the 1975 recession. However, employment has increased rapidly since the recession trough, especially in July.

Increases in employment have been broadly spread across industries. In manufacturing, the index of hours worked rose about 8.5 percent in the eight months through July; durable goods manhours by 10.8 percent. In the transportation equipment (auto) industry, callbacks and overtime increases raised the hours index by 17 percent during the eight months. Altogether, 76 percent of industries showed increased employment in the first half of 1983.

Industrial Production

Output in manufacturing utilities and mining increased 8.2 percent from its cyclical trough in November through the end of June. Production in the auto industry has grown particularly fast, but almost all industries have shown some increase. The Federal Reserve Board's measure of capacity utilization in all industries rose from its cyclical low of 69.6 percent to 74.5 percent in June. This still leaves capacity utilization below normal at this stage of a recovery.

Since 1978 the auto industry, like housing, has suffered from rising prices and high interest rates that pushed the cost of financing new purchases out of the reach of many consumers. Through a series of rebates and below-market financing plans, combined with drastic production cuts in the fourth quarter of 1982, the industry was able to cut auto inventories and

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2/ Counting resident military personnel as part of the labor force, the unemployment rate fell from 10.7 percent to 9.3 percent.

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return to more normal output levels in 1983. As a result unit auto production has increased 52 percent since the low in November, and current production schedules call for a further increase in the second half of 1983. The projected increase in auto production alone could add about $2\frac{1}{2}$ percentage points (at an annual rate) to the growth of GNP in the third quarter.

Output has also grown rapidly over the past six months in the furniture and appliance industries, and in the primary metals industries whose output goes into durable goods. Much of the increase in industrial production has therefore depended directly or indirectly on the growth of demand in interest-sensitive sectors of the economy.

Construction Activity

Residential construction has been the star performer of the economy in recent months. Housing starts, which fell to less than 900,000 units at the end of 1981, began to rise in the middle of 1982, and in the second quarter of this year reached 1.7 million units at an annual rate. Housing permits, too, have continued to rise and in June were almost twice the level of a year earlier.

The impact of this increase in residential construction activity on the economy has not yet been fully felt.

- The construction time for a new home is 3 to 6 months, with construction activity spread over this whole period. The value of new housing units put in place (in constant prices) has risen 66 percent since its low in May 1982, while housing starts are up 80 percent: thus, it is likely that a further increase in construction activity is still to come, based on the housing starts that have already occurred.

- When houses are completed, they must be equipped with furniture and appliances. This shows up as personal consumption expenditures on durable goods: these categories have recently begun to increase rapidly.

The strength of residential construction has not extended to the nonresidential sector. Private nonresidential building was down 10 percent between May 1982 and May 1983: but for the tail end of a boom in office construction, the decline would have been larger. Even office construction has been trending down over the past six months, in response to an increase in office vacancy rates.

Private nonresidential construction normally lags behind other categories of investment at cyclical upturns, partly because businesses do not wish to commit themselves to long-term investment while still earning recession profits. But there are signs of recovery in nonresidential building. The value of construction contracts for future starts of nonresidential buildings is up about 40 percent since the recession low. Nonresidential building activity rose slightly in June, the first increase in seven months, and the increase was spread over most of the components.

Inventories

The recession ended in the last quarter of 1982 with a rapid runoff of inventories, particularly of automobiles. The change from inventory accumulation to inventory reduction accounted for about 86 percent of the decline in production over the full recession from 1981:3 to 1982:4. Overall, the inventory decline has been the largest in the postwar period (Figure 6).

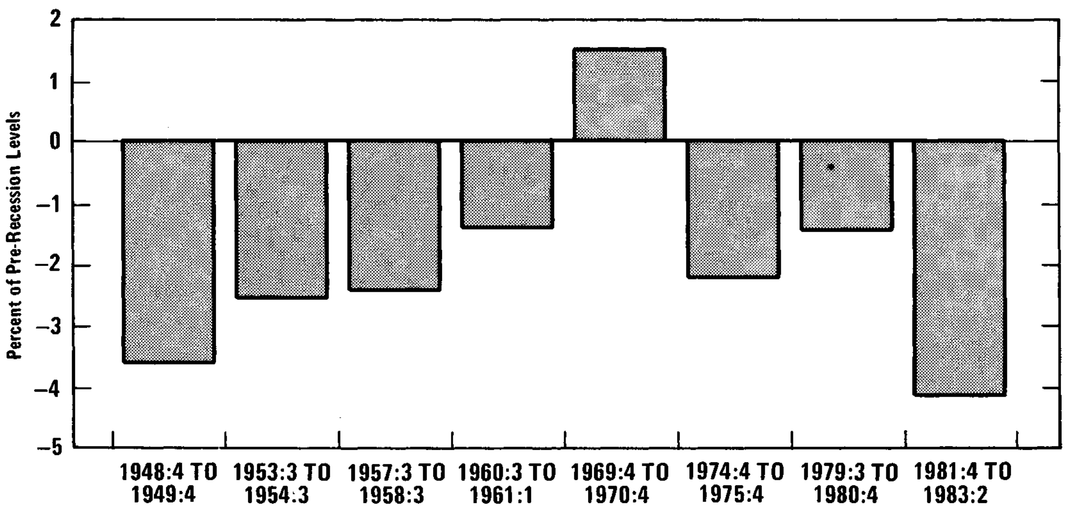
Inventories continued to decline in the first half of 1983, though at a much reduced rate in the second quarter. Unsold auto stocks remained approximately level. Because auto sales have increased substantially over this period, auto inventories are now low relative to sales (about 47 days' supply instead of the 60 often regarded as normal). Stocks of crude oil and petroleum products, which fell from November to March (contributing to this spring's reduction in world oil prices) rose sharply in July. 3/

High real interest rates, and uncertainty over the outlook for the economy, may still be influencing inventory stocking decisions. But it is likely that the reason for inventory declines in the second quarter was instead the rapid growth in final sales, which rose at a 6.3 percent annual rate. 4/ As a result, the ratio of inventory to shipments in manufacturing dropped from 1.71 in December to 1.59 in March and again to 1.49 in June. Further growth in demand will require increased production (and employment) to replenish depleted inventory stocks.

3/ Part of this increase is a normal seasonal increase in heating oil stocks. But gasoline stocks also rose, contrary to the normal seasonal pattern.

4/ After adjustment for Commodity Credit Corporation inventory change, which is treated as final sales in the National Income and Product Accounts.

Figure 6.
Changes in Real Inventories in Postwar Recessions



NOTE: There was no inventory reduction in the 1970 recession, and change shown is between peak and trough dates. For other recessions, changes are over the inventory cycle.

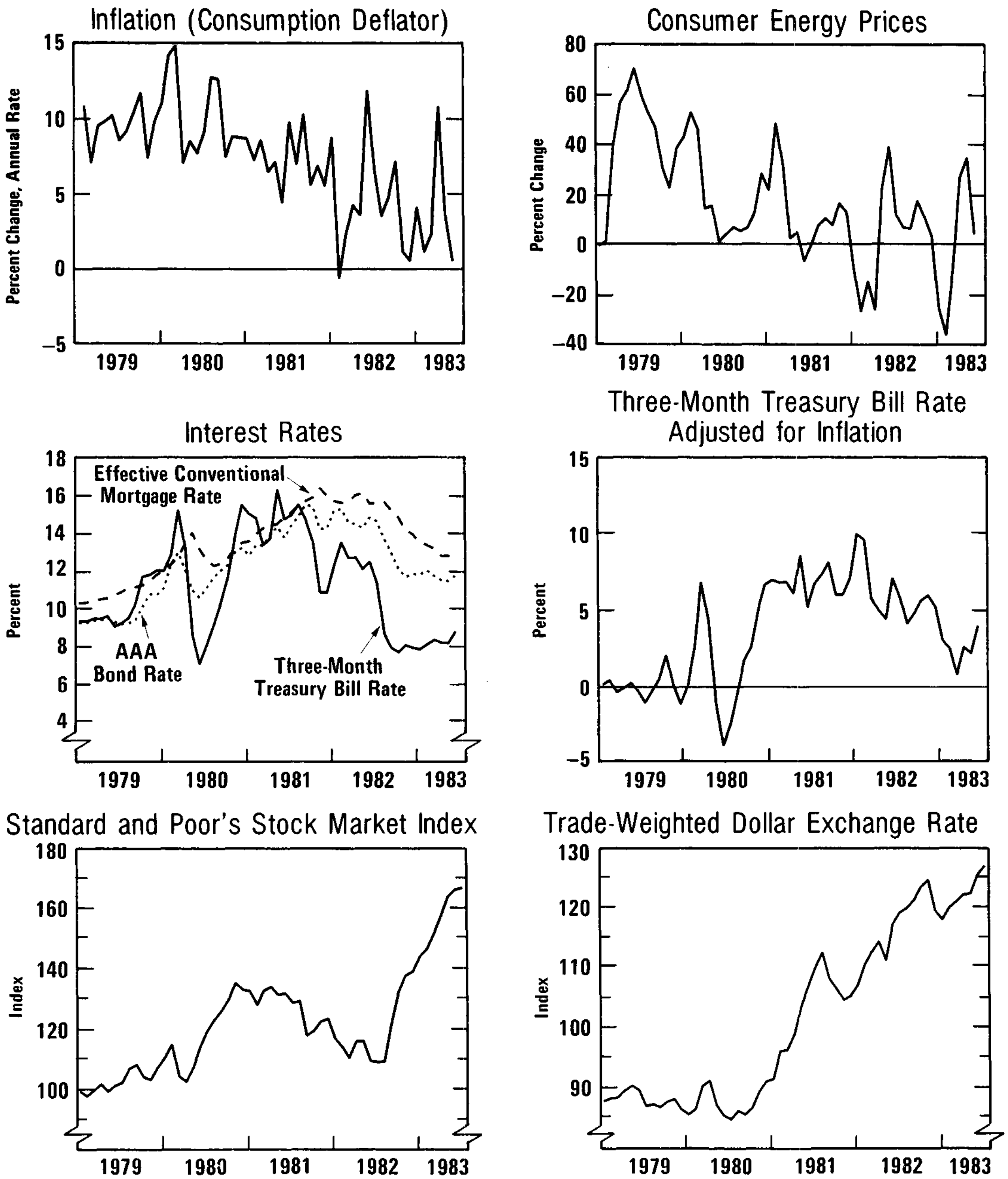
PRICES, INTEREST RATES, AND EXCHANGE RATES

A dramatic decline in inflation, a fall in interest rates from levels that were extraordinarily high to levels that are merely high, and the stock market boom have contributed to the improvement in economic conditions. Lower oil prices and a strong dollar have permitted rising real wages and helped to support consumption through the recession. But nominal wage growth itself has decelerated dramatically, both in the nonunion sector and in the major collective bargaining sector, which has often been more resistant to wage reductions in the face of recessions. Most analysts believe that the underlying rate of inflation has been sharply reduced over the past three years. But lower inflation so far has not been fully reflected in lower interest rates (Figure 7).

High interest rates continue to depress some sectors of the economy. They have kept the dollar exchange rate very high (some would argue, overvalued by about 20 percent relative to what it would be at more normal interest rates). The dollar's 50 percent appreciation since July 1980 has undoubtedly contributed to the fall in U.S. net exports. And high interest rates may also dampen the growth of residential construction and domestic investment, and restrict inventory rebuilding.

Figure 7.

Prices and Interest Rates



SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Board; Standard and Poor's; Federal Home Loan Bank Board.

This section examines the magnitude and durability of the decline in inflation, and looks at the effects of high interest rates and the strong dollar on the economy.

Reduction in Inflation

The impressive reduction in inflation in the past two years has continued in the first half of 1983. Consumer prices (measured by the CPI-U—the CPI for all urban consumers) fell in December and February, and rose at less than a 3 percent annual rate in the first half of 1983. Other inflation measures, too, have shown improvement recently: the Producer Price Index for finished goods actually fell from December to June and the fixed-weight GNP deflator, a broad measure of all prices in the economy, rose only 4.3 percent at an annual rate in the first half of the year. As recently as 1980, by contrast, the fixed-weight GNP deflator rose 9.6 percent and the PPI for finished goods rose 13.5 percent.

The reduction in inflation has reflected three factors:

- Much slower wage growth;
- Lower commodity prices, in particular lower oil prices; and
- A strong dollar, which has cut the cost of imports and trimmed margins in U.S. industries that engage in foreign trade. Lower import prices account for slower growth in the CPI than in the GNP deflator, which excludes imports.

Both the reduction in wage growth and lower commodity prices are the result of recession here and overseas. Stubbornly high U.S. interest rates, as well as uncertainties related to the debt crisis in developing countries, are responsible for the high exchange value of the dollar. Some analysts fear that recovery from recession, and perhaps a weakening dollar, could cause inflation to accelerate again. The likelihood of a quick acceleration in inflation does not seem great, however. Productivity growth is expected to be strong, so wages could grow much faster than they have recently without much impact on inflation. Some commodity prices are already responding to the recovery in economic activity. The grain harvest is expected to be down about 40 percent in 1983: this may push up meat prices in the second half of 1984, but large grain stocks and a good harvest next year would prevent a serious acceleration in food prices. Excess capacity in the oil industry seems sufficient to hold oil prices at their current levels through the end of 1984. A serious possibility for a resurgence of inflation lies in a fall in the exchange rate. A 10 percent fall in the course of a year might temporarily add about one percentage point to inflation—pushing the current underlying rate of inflation from the neighborhood of 5 percent to that of 6 percent. (At the same time, a decline in the dollar would stimulate U.S. output and employment). In addition, if the recent rapid growth in the money supply raises expected inflation, it may lead to higher wage claims and higher prices.

Oil Prices. World oil prices, which have been weak since 1980, dropped sharply early in 1983. World demand for oil products dipped in the recession, leaving refiners, distributors, and end users with excessive inventories of refined petroleum products that pushed down product prices in the second half of 1982. The OPEC oil producers had faced a similar situation earlier in 1982, but managed to avoid crude oil price cuts by an informal (and leaky) system of production rationing. OPEC was not so successful against the inventory drawdown at the beginning of 1983, which forced drastic cuts in crude oil prices and a more formal system of allocation of production. The final agreements, reached in March, called for a cut in the price of the Saudi marker crude from $34 to $29 per barrel.

Since April, it appears that market crude oil prices (though not official prices) have risen by about $1 per barrel. A new five-cents-per-gallon federal gasoline tax was introduced in April. Product prices have apparently risen by even more than this, and in July gasoline prices were only 3½ percent lower than their levels in mid-1982. Thus as far as the U.S. consumer is concerned, the oil price changes of early 1983 have been largely reversed.

Slowing of Wage Growth. A dramatic slowing of wage growth underlies the reduction in inflation (Table 8). This has been most visible in major national wage bargains struck over the past two years, which have frequently included one or more unusual features:

- Freezes or rollbacks of general wage increases, which in the past have included catch-up adjustments for previous inflation as well as increases in real wages (often at a rate averaging 3 percent per year);
- Delayed cost-of-living adjustments; and
- Shortened contract periods.

Contracts settled in the first half of 1983 included the smallest wage increases on record for major collective bargains. The average wage

TABLE 8. MEASURES OF WAGE AND COMPENSATION CHANGE FOR THE NONFARM BUSINESS SECTOR (In percent)

	Year Ending					
	Dec. 1978	Dec. 1979	Dec. 1980	Dec. 1981	Dec. 1982	June 1983
Compensation Change						
Compensation per Man-hour a/	8.9	9.6	10.8	9.0	7.2	6.1
Employment Cost Index b/	N/A	N/A	9.8	9.8	6.4	6.3
Union	N/A	N/A	N/A	10.7	7.2	7.0
Nonunion	N/A	N/A	N/A	9.4	6.0	5.9
Major Collective Bargaining Agreements c/						
First year	8.3	9.0	10.4	10.2	3.2	3.1
Average over life of contract	6.3	6.6	7.1	8.3	2.8	3.4
Wages and Salaries Change						
Average Hourly Earnings Index d/	8.5	8.3	9.2	8.2	6.0	4.6
Employment Cost Index b/	7.7	8.7	9.0	8.8	6.3	5.4
Union	8.0	9.0	10.9	9.6	6.5	5.6
Nonunion	7.6	8.5	8.0	8.5	6.1	5.4
Major Collective Bargaining Agreements e/						
First year	7.6	7.4	9.5	9.8	3.8	2.8
Average over life of contract	6.4	6.0	7.1	7.9	3.6	3.7

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis.

a/ Quarterly data, not adjusted for change in overtime or in industry or occupation mix.

b/ Adjusted for changes in overtime, and in industry and occupation mix.

c/ Settlements in the period covering 5,000 or more workers.

d/ Adjusted for overtime in manufacturing and for industry-mix changes.

e/ Settlements in period covering 1,000 or more workers. Excludes cost of living adjustments.